

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
REAL ESTATE HYBRID DEBT INVESTMENTS**

August 16, 2004

This Policy is effective immediately upon adoption and supersedes all previous real estate hybrid debt investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Real Estate Hybrid Debt Investments ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in the management process for capturing investment opportunities.

Real estate hybrid debt investments shall be subject to investment processes as described in the Statement of Investment Objectives and Policies for the Equity Real Estate Portfolio and the Delegation and Approval Guidelines.

II. STRATEGIC OBJECTIVE

Diversifying the equity real estate portfolio is the strategic objective of the Program. The System shall make such investments under the specified conditions and circumstances as described in this Policy.

Real estate hybrid debt investments allow the System to maintain the safety of its invested principal and potentially earn higher returns than through conventional mortgages. These investments allow the System to invest in properties that might not otherwise be available. In the case of convertible mortgages, the System can observe property performance prior to investment.

Real estate hybrid debt investments shall achieve a long-term real rate of return consistent with the overall objective of the Equity Real Estate Portfolio. The returns shall be greater than those available from conventional mortgages but are expected to be less than those from all

other equity investments. Investment selection shall preserve capital and achieve real rates of return.

III. INVESTMENT APPROACHES AND PARAMETERS

A. Investment Size

Real estate hybrid debt investment size should be measured by the amount of capital invested. Neither small nor large investments shall dominate the portfolio. Investment size should be in a range similar to other investments as set forth in the Statement of Objectives and Policies for the Equity Real Estate Portfolio.

B. Property Life Cycle

The System may invest in real estate hybrid debt investments comprised of existing and developmental projects. For development projects, funding shall occur when the property receives a certificate of occupancy and the occupancy percent meets the predefined minimum for the property.

For existing and development projects, forward commitments to fund the loan upon achievement of certain requirements may be made for no more than three years in the future. In cases where a property meets the minimum percentage leased requirements, but does not yet generate cash flow sufficient to cover debt service, the commitment amount may contain a debt service coverage reserve or a holdback reserve. The coverage or holdback reserve is for tenant improvement and leasing cost disbursements as needed during a lease-up period of no more than two years. Alternatively, the borrower may provide a letter of credit or appropriate income guarantees to cover the intervening lease-up period.

C. Property Types

The System shall consider real estate hybrid debt investments for all real estate property types.

D. Asset Selection Criteria

Analysis of potential real estate hybrid debt investments will be based on the physical, locational, and economic characteristics described in detail in the Investment Criteria in the individual core sector policies.

Physical attributes considered should include the site, property

size, exterior and interior characteristics, and building services, and amenities. Locational standards considered should include the socioeconomic market, neighborhood and site characteristics. Economic standards encompass analysis of the income and expense potential determining future cash flow and value enhancement.

E. Investment Vehicles

The System shall invest in real estate hybrid debt investments through investment advisors. Investment advisors shall provide expertise and experience in negotiating the complex real estate hybrid debt agreements. The advisors may present direct investment or commingled fund opportunities to the System. Fees paid for the advisors' services will be in relationship to the System's service requirements.

F. Selection of Investment Advisors

1. Selection of investment advisors is critical to the success of the Program. The System shall approve investment advisors based on their successful history in negotiating and monitoring real estate hybrid debt investments.
2. All advisors will be evaluated based on acquisition and asset management criteria including the following:
 - a. Significant experience in origination or asset management or both of real estate hybrid debt investments
 - b. Thorough understanding of the factors and issues involved in negotiating and managing real estate hybrid debt investments
 - c. Proven ability to successfully negotiate real estate hybrid debt agreements
 - d. Proven record of accomplishment in working with established borrowers

G. Borrowers

Borrowers shall be evaluated based on the following criteria:

1. Financial stability;

2. Significant past development or asset management experience or both with the proposed investment property type;
3. Significant local knowledge of the project's geographic area; and
4. Prior experience with real estate hybrid debt investments.

H. Investment Structure

1. Real estate hybrid debt investments have a typical structure, although the competitive forces of the market place ultimately determine the final terms of the transactions. Therefore, investment advisors shall remain flexible in negotiating such agreements. The System and its counsel reserve the right to review and approve all such agreements.
2. In general, negotiated agreements shall contain the following terms. When agreements differ from these terms, the advisor shall identify the differences and the reasons in its presentation to the System.
 - a. Loan Term - The loan term shall not exceed 20 years with the preferable term in the 10-15-year range. Shorter terms are acceptable with prepayment penalty provisions.
 - b. Loan Amount - In general, the loan amount should be such that the loan-to-value percentage shall not exceed 90 percent. However, the inherent uncertainty of market projections presents difficulties in determining the project's future value at the commitment date. If possible, the funding amounts for developmental projects shall undergo an appraisal at the funding date with the amount not exceeding 100 percent of the total budgeted costs or the actual costs, whichever is less.

The advisor or a third party shall verify costs, which may include reasonable development fees. The System shall monitor construction costs during the construction phase, as it deems appropriate.

Commitment amounts may contain an interest

reserve that may pay debt services during the lease-up period for developmental projects.

- c. Interest Rate - The interest rate for a loan that funds within ninety days after approval, shall not exceed 200 basis points below the conventional mortgage rate for the same term unless other terms of the transaction compensate for the lower rate. For forward commitments scheduled to fund more than ninety days after approval, interest rates should be higher to compensate for the additional risk.
- d. Loan Fees - Good faith loan fees are appropriate to ensure good faith performance from the borrower. Good faith deposits made at the time of application should be posted with the System. Upon commitment, good faith deposits can apply toward the commitment fee. Upon closing, any refundable portion would be refundable to the borrower. In some cases, bilateral contracts, which require other liquidating damages besides the good faith deposit or specific performance, may be appropriate.
- e. Participation in Cash Flow or Property Appreciation or Both - The participation feature may state that a percentage of cash flow or a preferred return to the System. It is preferable that the percentage of cash flow shall be at least 50 percent to compensate the System for the risk, but less than 80 percent to provide sufficient financial motivation to the borrower. The percentage should reflect current interest rates, the System's yield requirements, and the other terms of the transaction.

Participation payments should be paid at least quarterly and preferably on a monthly basis when cash flow permits.

The definition of real estate hybrid debt cash flow shall include gross revenues less operating expenses (including property management fees), debt service, and reserves for leasing commissions, property taxes, anticipated repairs, and capital improvements. The reserves shall accomplish the following goals:

- (1) Spreading the recognition of the cost of such

expenditures evenly over the period of the investment

- (2) Reducing the need for additional capital contributions
- (3) Reducing the potential disputes concerning past distributions in the event unexpected cash needs arise relating to prior periods, such as retroactive tax increases.

The System should also participate in value increases when they are recognized at refinancing or sale. It is preferable that the percentage of participation of the residual value defined in the agreement be the same as that of participation in operating cash flow, unless other terms of the transaction justify a lower or higher percentage.

The loan agreement shall define the manner of keeping property books and identify the timing and scope of an independent periodic audit of the property books. Property records shall comply with the System's Real Estate Accounting Policy and Reporting Guidelines. Distributions should be paid at least quarterly and preferably monthly.

- f. Conversion Terms and Timing – The debt agreement shall include the conversion terms, including percentages available for purchase, and the conversion date. Preferably, the conversion option shall be for not less than 50 percent ownership, thereby giving the System control of the investment.

By preference, the System shall have the option to convert after five-to-seven years, but no later than 10 years after loan funding, and at the end of the loan term. Multiple conversion date options are highly desirable.

The loan document shall include procedures for reconciling a disagreement over the purchase price. In the case of default, the conversion agreement shall be separately structured from the mortgage agreement and shall not be included as an additional remedy.

- g. Earnouts, Holdbacks, and Other Incentives - Where possible, the investment structure shall include incentives for the borrower to manage the property to achieve the highest long-term return for the System.
- h. Amortization: Loans shall be amortizing. Loans may be interest only or negatively amortizing for a small portion of the loan term if the participation or conversion features are sufficiently attractive to compensate for the additional risk. Loans that have an expected negative accrual (usually from interest due) shall be structured so that the expected accrual amount is included in the original commitment as a reserve. The reserve shall not be greater than 10 percent of the original funding.
- i. Debt Service Coverage - The debt service coverage ratio shall not be less than 1.05 times for a convertible loan or less than 1.10 times for participating only loans for any year without an interest reserve included in the loan budget. If applicable, full disbursement of the remaining interest reserve to the borrower shall not occur until the property achieves the target debt service coverage for a minimum of one year.
- j. Payment - Generally, no prepayment is allowed during the first half of the loan term or prior to the first conversion option date. Prepayment during the second half of the loan term shall include appropriate yield maintenance penalties, which include compensation for participation and equity conversions and contractual interest. Prepayment options must coincide with conversion options or the System's "call" option.
- k. Additional Capital Requirements. Provisions shall be made for the funding of additional capital requirements. These additional requirements may include tenant improvements or leasing commissions beyond the budget. To maintain a clear position for the System as lender, the borrower should be responsible for all additional capital requirements. Preferably, reserves shall provide the financing of additional capital requirements as described above. Should reserves be depleted, or determined to be

inadequate for future needs, the borrowers' own funds may pay additional contributions. The System may fund the additional capital requirements with the additional funding added to the loan balance, or a change made in the participation percentages, or both. The System shall not provide additional capital to fund debt service payments.

- l. Transfer of Interests - At any time during the loan term, the borrower shall have the right to sell only with the System's consent and approval of the new owner. The System should have the right to buy the property at the price offered to the third party.
- m. Call Option - It is preferable that the System have the right to "call" the loan if certain provisions are not met, for example, if additional required capital is not provided.
- n. Second Mortgages - The borrower shall place additional mortgages on the property only with the System's consent. If the borrower places additional mortgages on the property, the total debt service coverage shall be at least 1.10 times. The System's participation in property cash flow shall be calculated before the debt service in the second mortgage. Additionally, if exercising its equity conversion option, the System shall receive its share of the additional proceeds.
- o. Guarantees - The System prefers borrower guarantees for loans on properties that have not yet reached breakeven. The guarantee shall cover debt service requirements until the property reaches the minimum debt service coverage ratio.
- p. Decision making - Preferably, the System shall review and approve all major operating decisions. Major operating decisions include major leases, leasing plans, operating budgets, capital improvement expenditures, property management agreements, over-budget expenses, timing of refinancings, and timing of sales. The System prefers to specify the limits of insurance coverage and to request verification of such insurance. The borrower is responsible for daily property management decisions.

The borrower may perform property management in-house or may contract the services out to a property management firm. The Real Estate Hybrid Debt Investment Agreement shall provide for the System's right (according to ownership percentages) to approve the selection of the property manager and to terminate the manager with reasonable cause.

- q. Foreclosure/Default Protections - Where possible, the System shall strive for contract terms emphasizing the following protections:
 - (1) Maximum control during default;
 - (2) Loan workouts and foreclosure;
 - (3) Streamlined foreclosure processes to the extent allowed under local law; and
 - (4) The enforcement of minimum property maintenance standards during default and foreclosure periods.

IV. GENERAL

Hybrid debt investments are defined as mortgages having debt and equity features. The specific debt and equity features vary according to the real estate hybrid debt structure. Three examples of real estate hybrid debt investments are as follows:

- A. Participating Mortgages: The lender's return includes a contractually agreed upon amount of interest plus potential contingent interest expressed as a percentage of property operating cash flow, or a percentage of property appreciation upon sale or refinancing, or both.
- B. Convertible Mortgages: The loan structure includes a contractually agreed upon amount of interest and an option to convert a portion or all of the loan balance into a percentage of equity at a specified date.
- C. Convertible Participating Mortgages: The loan structure includes contractual interest, an option to convert part or all of the loan balance into equity at a specified date, and a percentage participation in property cash flow or appreciation upon sale or refinancing, or both.

V. GLOSSARY OF TERMS

The Real Estate Glossary of Terms is referenced in the System's Master Glossary of Terms.